

Supreme Court, U. S.
FILED

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*, Petitioners,

v.

HOWARD M. LASKER, *et ano.*, Respondents.

On Writ of Certiorari to the United States
Court of Appeals for the Second Circuit

**BRIEF FOR INVESTMENT COMPANY INSTITUTE
AS AMICUS CURIAE**

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**BRIEF FOR INVESTMENT COMPANY INSTITUTE
AS AMICUS CURIAE**

Investment Company Institute ("ICI") files this brief, as *amicus curiae*, in support of the petitioners' prayer that the judgment of the United States Court of Appeals for the Second Circuit entered herein on January 11, 1978 be reversed.

This brief is filed with the consent of the parties herein.

INTEREST OF THE AMICUS CURIAE

ICI is the national association of open-end investment companies (mutual funds), their investment advisers and principal underwriters. ICI has 462 investment company members, with approximately seven

million shareholders. The assets of the member funds approximate \$57 billion and account for over 90 percent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.*

ICI is concerned that, if permitted to stand, the Court of Appeals opinion will undermine the statutory role of independent, disinterested mutual fund directors; will leave the law concerning the authority and responsibilities of such directors in a state of confusion and disarray; and will result in the needless maintenance of litigation which independent directors determine, in the good faith exercise of their business judgment, not to be in the interest of the funds whose affairs they are responsible for governing. For the reasons stated *infra*, ICI respectfully submits that the decision of the Court of Appeals below was incorrect as a matter of law and, if permitted to stand, will substantially impair the proper operations of publicly held mutual funds under applicable state and federal law—to the detriment of both the industry and the investing public at large.

OPINIONS BELOW

The opinion of the Court of Appeals (A. 39) is reported at 567 F.2d 1208.¹ The opinions of the District Court (A. 5, 22) are reported at 426 F. Supp. 844 and 404 F. Supp. 1172.

¹ "A." refers to the single appendix filed in this Court.

JURISDICTION

The judgment of the Court of Appeals was entered January 11, 1978. A petition for rehearing was denied by order entered March 9, 1978. A petition for a writ of certiorari was granted by this Court on October 2, 1978. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b) (1970), and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b)(1974).

QUESTION PRESENTED

ICI adopts by reference the question stated by petitioners:

Are the disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, incapacitated *as a matter of law* from exercising their business judgment to determine whether maintenance of a stockholders' derivative action against the investment adviser and various directors of the fund to recover from them an investment loss sustained by the fund is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholders' derivative action be permitted to proceed, in any and all events, even though the disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

STATEMENT OF THE CASE

The pertinent facts as well as a descriptive history of the proceedings to date are set forth in the petitioners' brief.

To summarize briefly, this case was commenced by two shareholders in Fundamental Investors, Inc. ("Fundamental")—a Delaware corporation which is an open-end investment company (mutual fund) within the meaning of the Investment Company Act—purportedly as a derivative action on behalf of Fundamental. The complaint charged Fundamental's investment adviser, Anchor Corporation ("Anchor"), and all of the directors of Fundamental at the time in question, with violations of statutory and common law duties in connection with the decision in 1969 to make and retain an investment in commercial paper issued by Penn Central Transportation Company, on which payment was not made at maturity.

Following settlement of an earlier action initiated by Fundamental itself against the dealer selling the commercial paper involved—as a result of which Fundamental recovered a portion of its losses on this investment—a quorum of five disinterested directors, none of whom was a director at the time of the events complained of, undertook to consider what position Fundamental should then take regarding the derivative action. To assist in their deliberations, the disinterested directors retained as special counsel the Honorable Stanley H. Fuld, formerly Chief Judge of the State of New York.

Thereafter, based upon detailed legal and factual memoranda submitted to the Board by Judge Fuld indicating the derivative action to be without merit,

and considering the disadvantageous effects of the litigation upon Fundamental (including, *inter alia*, the cost of the litigation and the disruptive effect upon the working relationship between the fund and its investment adviser) (*see Affidavit of Leon T. Kendall, ¶ 22 (A. 69)*), the disinterested directors decided unanimously that maintenance of the action would not be in the best interest of the shareholders. They determined, therefore, to seek dismissal of the derivative action.

The District Court, after carefully reviewing "the many factors which the Board considered before making its decision not to sue" (A. 19), including those outlined in the Kendall affidavit, determined that:

"[i]f the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board." (A. 19-20).

The District Court then permitted discovery on the question of the directors' independence, including their relationships with the non-participating directors, to determine whether those directors who made the decision not to continue the action were in fact disinterested and independent.

Following extensive discovery on the issue of the independence of the disinterested directors, the District Court concluded that there was no evidence upon which their independence could be impugned. Accordingly, the District Court granted Fundamental's motion to dismiss.

On appeal, the Court of Appeals reversed. Although the independent directors' actions were duly authorized under the by-laws of the corporation and applicable Delaware law—and notwithstanding the impor-

tant responsibilities expressly entrusted to mutual fund independent directors by Congress in the Investment Company Act, as amended¹—the Court of Appeals felt that it would be “asking too much of human nature” to expect that the disinterested directors would act with the necessary objectivity in these circumstances in light of the “unique nature” of investment companies in general and their “symbiotic relationship” with their investment advisers. (A. 47-48).

The record in this case contains no suggestion of bad faith or self-dealing on the part of the disinterested directors or of any of the defendants:

1. The District Court found that plaintiffs failed to adduce “any factual support for their conclusion that the members of the disinterested quorum acted other than independently” in reaching their determination to seek an end to the derivative action. (A. 28) (emphasis added). The Court of Appeals stated that it had “no doubt that the five minority directors acted in good faith in all that they did.” (A. 48).²

2. The record is clear that the disinterested quorum was fully advised; its members were aware of the facts and acted with benefit of legal advice from distin-

guished special counsel in reaching their decision. The District Court found, and the Court of Appeals did not dispute, that

“the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them.” (A. 30).

3. In acting as they did, in part upon Judge Fuld’s opinion of the invalidity of the claims asserted in the derivative action and in part upon the various substantial business considerations that further militated against maintenance of the action, the disinterested quorum clearly acted well within the parameters of reasonableness. Unless the independent directors are barred from so acting by the policies or provisions of the Investment Company Act, their determination should not be set aside by the courts. The Court of Appeals did not question the reasonableness or good faith of the independent directors’ decision. Rather, the Court of Appeals ruled as a *matter of law* that disinterested mutual fund directors lack the power to terminate a “non-frivolous” shareholder derivative suit: that is, presumably, any litigation which on its face could withstand a motion for judgment on the pleadings. The Court of Appeals did not cite any specific statutory basis for its conclusion.

In these circumstances, ICI respectfully submits that the disinterested directors acted within the limits of their lawful discretion, and that the judgment of the Court of Appeals must be reversed.

¹ See *infra* pp. 15-17.

² Nor do even the allegations of the complaint charge that the defendant directors and investment adviser realized any personal gain from the fund’s purchase of Penn Central commercial paper; rather, the gravamen of the action is that the defendants were remiss in their responsibilities in making, or acquiescing in, the decision to purchase Penn Central paper in light of the information about the financial condition of the company which, plaintiffs charge, might have been obtained at the time of purchase if a more thorough review of the investment had taken place.

ARGUMENT

I. The Decision Below Undercuts the Statutory Role for Independent Directors Established by Congress in the Investment Company Act and Will Have Significant Adverse Effects on These Directors and the Operations of the Funds They Serve

A. THE COURT OF APPEALS DECISION IMPROPERLY RESTRICTED THE ROLE OF INDEPENDENT DIRECTORS

The role of disinterested mutual fund directors was first established by the Investment Company Act of 1940 and legislatively reinforced and expanded after extensive consideration by Congress in the 1970 amendments to that Act.¹ These unaffiliated directors were

¹ While the Court of Appeals in this case relied upon its assessment of "human nature" in rejecting the role of independent directors (A. 47), Congress had, over a period of four years, fully and carefully considered that role as well as the operations and structure of the mutual fund industry when it debated and enacted the 1970 amendments to the Investment Company Act. See, e.g., S. Rep. No. 91-184, 91st Cong., 1st Sess. 1 (1969) ("During the last three years, this Committee held extensive hearings and executive sessions on this subject matter. This proposed legislation was also debated at length on the Senate Floor in July 1968."); Investment Company Amendments Act of 1970, Conference Report (S. 2224), Rep. No. 91-1631, 91st Cong., 2d Sess. (1970); Investment Company Amendments Act of 1970, Report of the House Committee on Interstate and Foreign Commerce on H.R. 17333, H. Rep. No. 91-1382, 91st Cong., 2d Sess. (1970); Hearings before the Subcommittee on Commerce and Finance, House Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 (Mutual Fund Amendments, Parts 1 and 2), No. 91-33, 34, 91st Cong., 1st Sess. (1969); Hearings before the Senate Committee on Banking and Currency on S. 34 and S. 296, Investment Company Amendments Act of 1969, 91st Cong., 1st Sess. (April 15, 17 and 18, 1969); Investment Company Amendments of 1969, Analysis of S. 34, Senate Committee on Banking and Currency, 91st Cong., 1st Sess. (1969); Investment Company Amendments Act of 1968, Report of Senate Committee on Banking and Currency on S. 3724, S. Rep. 1351, 90th Cong., 2d Sess. (1968); Hearings before a Subcommittee of the Senate Committee on Banking and Cur-

viewed as "watchdogs" over the interests of the shareholders and charged under the statute with reviewing and approving contracts and matters in which the manager had an interest, such as the fund's management and underwriting contracts.² Congress viewed independent directors as providing "an independent check on management. . . ." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

On an industry basis, mutual funds make literally tens of thousands of investment decisions each year with respect to billions of dollars of assets which are managed for the benefit of millions of shareholders. Each one of these thousands of investment decisions which, with the benefit of hindsight, was a poor decision gives rise to the possibility of a derivative action in which one or more disappointed shareholders may seek to recover on behalf of the fund the full amount of the loss from the investment adviser, affiliated directors and others.

The role of independent directors, who are not defendants or otherwise personally interested in the outcome of the action, has been improperly restricted by the decision below. Congress expressly stated that the provisions of the Investment Company Act were "not intended to shift the responsibility for managing an

rency on S. 1659, Mutual Fund Legislation of 1967, 90th Cong., 1st Sess. (July 31, August 1-4, 14-15, 1967); Investment Company Amendments of 1967, S. 1659 (Comparative Print and Analysis of S. 1659), Senate Committee on Banking and Currency, 90th Cong., 1st Sess. (1967); Report of the SEC to Congress on the Public Policy Implications of Investment Company Growth, H. Rep. 2337, House Committee on Interstate and Foreign Commerce, 89th Cong., 2d Sess. 332-35 (1966).

² See *infra* pp. 16-17.

investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). If the independent members of a mutual fund board of directors determine that the institution or maintenance of the claims set forth in a derivative action would not be in the interest of the fund—*e.g.*, because they determine the claims to be without merit or because of other proper considerations—they should have discretion to refuse to approve or to seek dismissal of the action. As the Securities and Exchange Commission recently stated, the independent directors should be able to exercise "their business discretion in the best interests of the fund shareholders. . . ."^{**} Under the decision below, however, the disinterested directors are precluded from acting in what they believe to be the fund's best interest. They must sit back and **refrain** from acting so long as the claims asserted in the derivative action are not patently "frivolous."

If disinterested directors cannot exercise their independent business judgment in such circumstances, the intent of Congress that disinterested mutual fund directors exercise their business judgment to determine what actions should be taken to protect the interests of all of the shareholders will be frustrated.

For the role of the independent mutual fund director to be an effective one, it is important that individuals of ability, experience and integrity agree to accept these positions. The decision below—which wrongfully withdraws from independent directors their authority

* Brief of the Securities and Exchange Commission, *Amicus Curiae* at 28, *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), cert. denied, 434 U.S. 934 (1977).

to exercise their good faith business judgment in the interest of the fund and which unfairly denigrates such directors as a class by the unsupported assumption that they must be, as a matter of law, incapable of acting with objectivity—will hinder, not help, efforts to encourage responsible individuals to serve in this role. Rather than enhancing the operation of mutual funds in the interest of the vast majority of shareholders, the decision below will emasculate the role of the "independent watchdog" director that Congress selected and in 1970 reaffirmed as a "key" means of assuring that investment companies are in fact run for the benefit of their shareholders. *See, e.g., Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).

B. THE DECISION BELOW WILL ENCOURAGE AND COMPEL THE MAINTENANCE OF LITIGATION THAT IS NOT IN THE BEST INTEREST OF MUTUAL FUND SHAREHOLDERS

If independent mutual fund directors cannot exercise their business judgment to refuse to approve or seek dismissal of litigation they determine to be not in the best interest of the fund they serve, then ICI submits that significant undesirable results can and will occur:

First, costly and time-consuming litigation will be maintained involving claims that the independent directors of mutual funds—the persons most likely to be both knowledgeable and objective—determine to be without merit or, on balance, of such little merit as not to justify the expense and other burdens of ongoing litigation. Mutual fund investment advisers regularly make thousands of investment decisions, some of which

result in losses and could give rise to litigation. The decision below will operate to remove an existing protection against the maintenance of unsound or questionable suits of this nature, which are unlikely to be in the interests of the fund or its shareholders, on whose behalf they purport to be brought. The proliferation of such actions is neither in the public interest nor the interest of the judicial system. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-43 (1975).

Second, to the extent that the maintenance of such derivative suits impairs the working relationship between mutual funds and their investment advisers, a derivative action on behalf of one or two shareholders may effectively frustrate the expectation of thousands of other shareholders.⁷ If litigation desired by one or two shareholders is allowed to impair the relationship between a fund and its adviser without sufficient cause, the expectations of other investors who have chosen the fund on the basis of its adviser's past performance and reputation will not be realized.

Third, the uncontrolled maintenance of the sort of claims involved in this case poses the threat of severe disruption of the operations of the mutual fund industry—particularly with respect to the activities of the funds' investment advisers.

⁷ Among the considerations weighed by the disinterested directors were the possible disruptive effects of continuing the action in these circumstances; the creation of an adversary relationship between the fund and the adviser; the diversion of personnel; and the burdens imposed on the adviser. (A. 77-78). These matters, among other things, were clearly appropriate considerations for the directors to weigh.

Investment advisers to mutual funds are entrusted with the management of large amounts of assets, in exchange for which they receive compensation which is customarily calculated on the basis of a small percentage of the fund's assets. In this case, for example, the damages sought could be 200 times as great as the investment adviser's annual fees attributable to management of the assets in question.⁸ The spectre of defending lawsuits brought by dissatisfied shareholders essentially seeking to make the investment adviser the guarantor of the investments selected is likely to have an adverse, disruptive effect upon the operations of the mutual fund industry.⁹

II. The Decision Below Improperly Applies the Provisions and Policies of the Investment Company Act to Reach a Result That Is in Conflict With the 1970 Amendments to That Act and With Controlling State Law

The quorum of disinterested directors, acting pursuant to the by-laws of the corporation and in accordance with Delaware law, acted within the scope of their discretionary authority in this case.

⁸ Aneher's contract with Fundamental provided that Anchor would receive approximately 0.5% of the value of the assets managed as an annual fee. (Jt. App., p. 194A) ("Jt. App." refers to the Joint Appendix filed in the Court of Appeals).

⁹ The issues for review in this case do not require the Court to determine whether damages could ever be recovered on this basis and, if so, in what circumstances. ICI merely points out that the *in terrorem* effect of suits seeking damages out of all proportion to an investment adviser's income, if they may be brought at the instance of a single shareholder without any meaningful prior screening, will be substantial.

Under Delaware law, a lawfully-constituted quorum of directors is charged with managing “[t]he business and affairs of every corporation . . . except as may be otherwise provided. . . .” Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b) (1974). In discharging this broad supervisory responsibility, it is well-settled law that directors of corporations generally need not pursue every conceivable legal claim—especially “where the right of the corporation to recover is doubtful”:

“The mere fact that a corporation has a cause of action for an injury does not always make it incumbent upon it to sue, any more than in the case of an individual. If, in the opinion of the directors or a majority of the stockholders, the interests of the company do not require it to sue, it need not do so. The matter ordinarily is within their discretion, and if they act in good faith, their refusal to sue violates no right of dissenting stockholders, so as to entitle them to maintain a suit in their own behalf.” 13 *Fletcher Cyc Corp. (Perm Ed)* § 5822 (1970) (footnote omitted).

See, e.g., United Cooper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903); *Ash v. IBM*, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); *Alleghany Corp. v. Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), cert. dismissed, 384 U.S. 28 (1966); *Warshaw v. Calhoun*, 43 Del. Ch. 148, 221 A.2d 487 (Sup. Ct. 1966).

Moreover, if a quorum of disinterested directors is available to pass upon such matters, they are not prevented from determining to dismiss a pending action

simply because the composition of the board may have changed between either the time when the cause of action arose or the complaint was filed, or because the “interested” directors recuse themselves from the decision-making process after a shareholder derivative suit has been filed to compel prosecution of the corporation’s alleged claims.¹⁰ *See, e.g., Brody v. Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), cert. denied, 414 U.S. 1104 (1973), on remand, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), aff’d 517 F.2d 932, 934 (2d Cir. 1975); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Independent Investor Protective League v. Saunders*, 64 F.R.D. 564, 570-71 (E.D. Pa. 1974).

If the result below can be justified, therefore, it must be premised upon the Investment Company Act of 1940, which was enacted in part because of the special nature of the investment company industry to which the Court of Appeals referred. However, neither the statute nor its underlying policies (Section 1(b)) compel the departure from established principles indulged in by the Court of Appeals. On the contrary, they compel precisely the opposite result.

¹⁰ Plaintiffs in this case have raised the spectre that, in such circumstances, “[a] controlling majority of defendant directors could create a disinterested quorum after the litigation had commenced by rotating themselves out of office until a quorum perceived as friendly were available to exercise business judgment.” *Respondents’ Brief in Opposition to the Petition for Certiorari*, at p. 20. Any such abuses, of course, can be guarded against by permitting plaintiffs—as the District Court did in this case—full discovery with respect to the method of selection and other indicia of the actual independence of the directors who comprise the disinterested quorum.

When it amended the Investment Company Act in 1970, Congress specifically considered the problem of the influence exerted by the investment adviser over the unaffiliated directors. Congress nevertheless chose to *reject* proposals for significant structural changes in investment company governance and instead adopted additional safeguards keyed to the important role of independent directors. Specific new provisions, which were designed to assure their independence and strengthen the independent checks on management, were adopted.¹¹

For example, Congress added Section 2(a)(19) defining the term "interested person" and substituted that new broader concept for the term "affiliated person" as used in Section 10, which requires at least 40 percent of each fund's board to be disinterested persons. It also amended Section 15 of the Act governing ratification of advisory (management) and underwriting contracts by the board, to require approval "by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party. . . ." Congress also reinforced the statutory role of independent fund directors by amending Section 36. The Senate Report stated:

"These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

¹¹ See, e.g., Part E: Strengthening Independent Checks on Investment Company Management, S. Rep. No. 91-184, 91st Cong., 1st Sess. 32-34 (1969) (discussing amendments to Sections 2(a), 10, 15 and 32(a) adding the term "interested person").

Thus, it is clear that independent directors of mutual funds were intended by Congress to have a significant measure of authority and responsibility in the exercise of their business judgment in such sensitive areas as approval of management and underwriting contracts. There is no basis in the statute, express or implied, for precluding the exercise of such judgment by independent directors in the area of fund litigation, when the exercise of discretion is permitted—indeed mandated—in much more sensitive areas of greater consequence to the operations of mutual funds. To do so unnecessarily displaces the corporate mechanism recognized and strengthened by Congress with the viewpoint of a court, in a situation where judicial intervention is not required to safeguard the interests of shareholders.

III. The Court of Appeals Decision Represents an Unsupportable Departure From Existing Decisional Law Concerning the Role of Independent Directors Under the Investment Company Act

Prior to the decision below, no court had interpreted the Investment Company Act to restrict so narrowly the role of the independent directors as the Court of Appeals did in this case. On the contrary, the cases arising under the Act—both in the Second Circuit and in other Circuits—makes clear that the decisions below severely undercuts the purposes of the statute and, in particular, the amendments passed by Congress in 1970 for the express purpose of *expanding* the responsibilities of independent directors of mutual funds.

A. THE DECISION IS INCONSISTENT WITH THE "DEMAND" CASES

Thus, in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973), the First Circuit refused to permit a shareholder derivative action on behalf of a mutual fund, where the shareholder had not initially made a demand upon the independent directors. The court affirmed the primacy of the determinations of independent directors in the area of litigation, stating:

"All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." *Id.*, 479 F.2d at 266-67 (citations omitted).

As the *Kauffman* court explained:

"We recognize the social desirability of bona fide, well founded minority suits. We also recognize the tremendous waste involved in suits that are not well founded." *Id.*, 479 F.2d at 267.

See also Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. denied, 404 U.S. 994 (1971). Cf. *Heit v. Baird*, 567 F.2d 1157, 1162-63 n.6 (1st Cir. 1977).

The fundamental premise of decisions requiring a demand on directors, whether or not they involve mu-

tual funds, is that the directors of a corporation are the proper persons to pass on whether an action on behalf of the corporation should be maintained, unless plaintiffs establish the directors' bias or lack of independence. In this case, the deciding quorum of directors consisted entirely of individuals who (1) were charged with performing a particular statutory function, under the Investment Company Act, to protect the interests of all the shareholders; (2) were found by the District Court to be truly independent in fact as well as in theory; and (3) were not named as defendants or involved in any way in the litigation which they determined it would in the best interest of the fund not to pursue. The Court of Appeals' rejection of the business judgment of the disinterested quorum, in these circumstances, cannot be sustained.

B. THE DECISION CONSTITUTES AN UNJUSTIFIED DEPARTURE FROM THE BUSINESS JUDGMENT STANDARD EXPRESSED IN *Tannenbaum v. Zeller*

The decision below also represents an abrupt and unjustified departure from the Second Circuit's own determination in *Tannenbaum v. Zeller*, *supra*, which sustained the validity of the exercise of the sound business judgment of independent directors with respect to the issue of whether mutual funds need in all circumstances seek to "recapture" brokerage commissions. There, the Court of Appeals for the Second Circuit stated:

"We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors." *Id.*, 552 F.2d at 417.

The court in *Tannenbaum* concluded:

"Thus the decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors." *Id.*, 552 F.2d at 418-19 (footnote omitted).

The record establishes that the three elements of the *Tannenbaum* standard were satisfied in this case. The District Court's decision clearly found (1) that the deciding directors were independent (*i.e.*, they were not "dominated" or "unduly influenced"); and (2) that they had acted only after careful and full exploration of the situation, with the advice of distinguished independent counsel (*i.e.*, they were "fully informed"). Moreover, it is clear from the opinion and the result reached that the District Court believed that the directors' determination not to continue the action in this case was well within the range of reasonable business judgment contemplated by the third element in *Tannenbaum*.¹² The District Court expressly found that the disinterested directors acted independently.

¹² ICI submits that the *Tannenbaum* decision may go too far in suggesting that the federal courts exercise plenary jurisdiction to review the "reasonableness" of lawful business decisions by corporate directors. While the facial reasonableness of a decision by the directors might be weighed by the court along with other

This finding was not disturbed by the Court of Appeals, which also found that the disinterested directors acted in "good faith."¹³

Instead, the Court of Appeals based its reversal of the District Court's decision in this case on the startling and unprecedented determination that the independent and statutorily disinterested directors of a mutual fund are incapacitated *as a matter of law* from ever exercising their business judgment to terminate "non-frivolous" actions against the fund's investment adviser and affiliated directors.¹⁴

evidence in passing upon whether the disinterested directors in fact made an independent and informed determination, no statutory or decisional basis empowers the federal courts to second guess the wisdom of directors' decisions as such. *See, e.g., Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 343 (1936) (Brandeis, J., concurring); *Warshaw v. Calhoun*, *supra*, 221 A.2d at 492-93. On the record in this case, however, it is not necessary for this Court to determine that issue, since the reasonableness of the decision of the disinterested directors could not be seriously disputed.

¹³ The District Court stated:

"The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision." (A. 19).

¹⁴ Indeed, affirmance of the District Court's decision in this case should have followed *a fortiori* from *Tannenbaum*. In *Tannenbaum*, the decision in issue—whether the fund could forego "recapture" of excess brokerage commissions—involved a determination by the disinterested directors with respect to matters in which the "interested" directors could have some personal financial interest. The conduct plaintiffs seek to challenge in this case, in contrast, does not involve any such potential conflict. There is no suggestion in the record that either the directors or the adviser benefited in any

C. THE BASIS FOR THE DECISION IS NOT SUPPORTED BY THE AUTHORITIES CITED BY THE COURT OF APPEALS

The Court of Appeals cited only two "authorities"—one case and one law review article—in support of the cornerstone to its decision in this case: that is, the proposition that it would be "asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." (A. 47). Neither the one case nor the law review article cited by the Court of Appeals supports this assertion. (A. 47 n.13).

In *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the court found that there had been "inadequate communication to the independent directors" with respect to the matters in issue. 533 F.2d at 750. The court in *Fogel* did *not* say that fully informed and independent directors were incapable of responsible decision-making; it said exactly the opposite:

"Congress . . . mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' The minimum requirement to enable the Fund's independent directors to discharge

manner from the decision to purchase Penn Central commercial paper. To the contrary, since the adviser's fee was based upon a percentage of the fund's net asset value, when an investment declined in value, the adviser also lost income.

[their] duties . . . was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of [the facts] and their legal consequences performed by disinterested counsel furnished to the independent directors.

"If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort [to pursue the matter], we would have a different case." 533 F.2d at 749-50 (footnotes and citations omitted) (emphasis added).

In Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179 (1971), the author merely points out that, prior to the 1970 amendments to the Investment Company Act, certain "studies of the [mutual fund] industry [had] been critical of the adviser's handpicking of new directors." *Id.* at 216. The article does not take the position that mutual fund directors can never be trusted to act independently; it expressly rejects the views of those who would espouse such unsupported generalizations:

"Why such a pessimistic view prevails among many critics of the independent director concept is not entirely clear. . . . The 1970 Amendments' definition of 'interested persons' eliminates from independent director status anyone with a material business, professional, or personal relationship with the adviser. In addition, many independent directors are now selected by their predecessors, and may seek advice from other independents rather than advisers' personnel. There is no reason to assume that if the independent direc-

tors are aware of a problem area they cannot deal appropriately with it. . . . Moreover, most directors are unquestionably men of intelligence and ability who can survey material quickly and act responsibly within a short period of time." *Id.* at 265-66 (emphasis added).

There is simply no justification—in the statute, in its legislative history, in other pertinent cases or in public policy—for the result reached by the Court of Appeals below.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment of the Court of Appeals below, and should remand with instructions to reinstate the judgment of the District Court dismissing the complaint.

Respectfully submitted,

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